SUPREME COURT, U.S.
FILED
DEC 24 1980
MICHAEL RODAK, JR., CLERK

No. 79-1907

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

PORTLAND CEMENT COMPANY OF UTAH,
Respondent

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

BRIEF OF AMICUS CURIAE

RICHARD A. FRELING
DAVID G. GLICKMAN
WILLIAM P. BOWERS

JENKENS & GILCHRIST
2200 First National Bank Building
Dallas, Texas 75202
(214) 653-4308

Counsel for Centex Corporation

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

No. 79-1907

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

PORTLAND CEMENT COMPANY OF UTAH,
Respondent

On Writ of Certiorari to the United States Court of Appeals for the Tenth Circuit

---

BRIEF OF AMICUS CURIAE

INTEREST OF AMICUS CURIAE

Through its counsel, Richard A. Freling, David G. Glickman and William P. Bowers, Centex Corporation, acting as an amicus curiae, herewith submits this brief in support of the Respondent, Portland Cement Company of Utah, in the above-styled case now before the United States Supreme Court. Centex Corporation has an interest in the resolution of this case by reason of its ownership of integrated miner-manufacturers of cement.

TABLE OF CONTENTS

	Page
STATEMENT OF CASE	1
SUMMARY OF ARGUMENT	2
ARGUMENT	5
I. The incremental income and costs attributable to the Respondent's post-manufacturing processes must be excluded entirely from the proportionate profits formula	5
A. Introductory statement	5
B. The incremental income and costs incurred subsequent to the production of finished cement must be excluded from the proportionate profits formula, since the Respondent's first marketable product is finished cement sold in bulk at its plant	9
C. The incremental income from and costs of the post-manufacturing operation must be excluded entirely from the formula in order to give proper effect to the assumption upon which the proportionate profits method is based (*i.e.*, every dollar of cost earns the same percentage of profit)	18
II. The Respondent's selling expenses are not directly identifiable with either a particular mining or nonmining process. Accordingly, selling expenses must be apportioned between mining and nonmining by a reasonable method, unless the decisions of the Tenth Circuit are followed and selling expenses are excluded entirely from the proportionate profits fraction	25
CONCLUSION	29
APPENDIX A	A-1
APPENDIX B	B-1

TABLE OF AUTHORITIES

Page

CASES:

Arvonia-Buckingham Slate Co. v. United States, 426 F.2d 484 (4th Cir. 1970), *vac'g and rem'g*, 69-2 U.S.T.C. ¶9583 (E.D. Vir. 1969) 26,27,28,30

Ayers Materials Co., 62 T.C. 557 (1974) 13

Dravo Corp. v. United States, 348 F.2d 542 (Ct. Cl. 1965)..... 13

General Portland Cement Co. v. United States, 628 F.2d 321 (5th Cir. 1980), *aff'g in part, rev'g in part, and rem'g in part*, 438 F. Supp. 27 (N.D. Tex. 1977)..... 10

Mississippi Valley Portland Cement Co. v. United States, 347 F. Supp. 240 (S.D. Miss. 1972) 10,29

North Carolina Granite Corp., 56 T.C. 1281 (1971), *acq.*, 1974-2 C.B. 3, *nonacq.*, 1974-2 C.B. 5 7,9,21-22

Portland Cement Company of Utah v. Commissioner, 614 F.2d 724 (10th Cir. 1979), *cert. granted*, 101 S. Ct. 69 (1980) 10,11,17

Russell Manufacturing Co. v. United States, 175 F. Supp. 159 (Ct. Cl. 1959)..... 17

Southwestern Portland Cement Co. v. United States, 435 F.2d 504 (9th Cir. 1970), *aff'g in part, rev'g in part and rem'g in part*, 69-1 U.S.T.C. ¶9110 (C.D. Calif. 1968) 10,26,27,30

Standard Lime & Cement Co. v. United States, 329 F.2d 939 (Ct. Cl. 1964)..... 7,10,12,29

Standard Realization Co. v. United States, 289 F.2d 247 (7th Cir. 1961), *aff'g in part, rev'g in part, and rem'g in part*, 184 F. Supp. 714 (N.D. Ill. 1960)..... 12-13,16,19

United Salt Corp., 40 T.C. 359 (1963), *acq.*, 1973-2 C.B. 4, *aff'd*, 339 F.2d 215 (5th Cir. 1964) 10,13,16,19

United States v. California Portland Cement Co., 413 F.2d 161 (9th Cir. 1969), *aff'g in part, rev'g in part, and rem'g in part*, 67-1 U.S.T.C. ¶9458 (C.D. Calif. 1967) 10,26,27,28,29

Page

United States v. Cannelton Sewer Pipe Company, 364 U.S. 76 (1960), *rev'g and rem'g*, 268 F.2d 334 (7th Cir. 1959) 14-15,17,20,24-25
United States v. Cartwright, 411 U.S. 546 (1973), *aff'g*, 457 F.2d 567 (2d Cir. 1972) 17
United States v. Ideal Basic Industries, Inc., 404 F.2d 122 (10th Cir. 1968), *cert. denied*, 395 U.S. 936 (1969) 4,6,9,10,12-13,17,25,29
United States v. Portland Cement Company of Utah, 378 F.2d 91 (10th Cir.), *cert. denied*, 389 U.S. 975 (1967) 22
Whitehall Cement Manufacturing Co. v. United States, 369 F.2d 468 (3rd Cir. 1966), *aff'g*, 242 F. Supp. 327 (E.D. Penn. 1966), 242 F. Supp. 326 (E.D. Penn 1966), 237 F. Supp. 838 (E.D. Penn. 1965) 10

STATUTES AND REGULATIONS:

Internal Revenue Code of 1954 (26 U.S.C.):
Section 611(a) 5
Section 613 16,24
Section 613(a) 5
Section 613(b)(7) 5
Section 613(c) 5,14,15
Section 613(c)(4) 16
Section 613(c)(4)(A) 15-16
Section 613(c)(4)(B) 15-16
Section 613(c)(4)(C) 15-16
Section 613(c)(4)(F) 6

Internal Revenue Code of 1939:
Section 114(b)(4)(B) 14

Public Debt and Tax Extension Act of 1960, Pub. L. 86-564, 86th Cong., 2d Sess. 14,15

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):
Section 1.613-4(b)(1) 6
Section 1.613-4(c) 23

Page

Section 1.613-4(c)(1) 6
Section 1.613-4(c)(6) 23-24
Section 1.613-4(d)(1)(i) 6
Section 1.613-4(d)(4) 7-8
Section 1.613-4(d)(4)(iii) 26-28
Section 1.613-4(d)(4)(iv) 11,14,16-17
Section 1.613-4(d)(4)(v) 7,8
Section 1.613-4(e)(2) 19
Section 1.613-4(g)(4) 11,16
Section 1.613-5(a) 5
Section 1.613-5(c)(4)(ii) 26-28

Treasury Regulations 118 (1939 Code):
Section 39.23(m)-1(e)(3) 8

REVENUE RULINGS:
Rev. Rul 72-476, 1972-2 C.B. 288 16

MISCELLANEOUS:
Collier, "The New Depletion Regulations," 1970 Tulane Tax Institute 510, 530 (1970) 24

STATEMENT OF CASE

Finished cement is the product of both a mining and manufacturing operation. A business engaged in the production of cement is, therefore, engaged in both a mining and manufacturing operation and is commonly referred to as an integrated miner-manufacturer. To produce cement, the integrated miner-manufacturer may employ one of two operations: a "dry process" or a "wet process."

In the case at bar, the Respondent utilized the wet process to produce its cement. The mining phase of the wet process commences with the extraction of calcareous raw materials, continues as the extracted raw material is ground and blended with water, and ends with the production of a mixture referred to as "slurry" or "kiln feed." The manufacturing phase starts with the introduction of the kiln feed into a revolving kiln where the mixture is burned. The burned mixture is cooled and then ground together with additives to a fine powder, which is finished cement. The manufacturing phase terminates with the production of finished cement.

The Respondent sells finished cement either in bulk or in paper bags. When an order for bulk cement is received, the cement is loaded directly from storage silos into railcars or onto trucks. Finished cement sold in bags is conveyed from the silos to bagging machines, and after the bags are filled according to weight, the bags are loaded onto trucks or into railcars for shipment.

The Respondent charges a higher price for the cement sold in bags. This additional amount is referred to in the industry as the "bagging premium," which is intended to recompense the seller for the incremental costs incurred to bag the cement, *i.e.*, the cost of bags and bagging. With respect to the years in controversy, the premium was not sufficient for the Respondent to recoup the cost of the bagging operation and bags.

The Respondent sold both bulk and bag cement from its plant and from a distribution terminal. With respect to its products sold, the Respondent incurred selling expenses.

The case at bar involves a determination of the Respondent's depletion allowance for the years in controversy, which is calculated with reference to the Respondent's gross income from mining. Because the Respondent is an integrated miner-manufacturer of cement, and no market existed for its kiln feed, the calculation of its depletion allowance necessarily required that its gross income from mining activities be determined by an indirect method. The issues in this case focus on these calculations.

SUMMARY OF ARGUMENT

I. A. The Respondent, as an integrated miner-manufacturer of cement, is entitled to a depletion allowance based upon the gross income derived from its mining activities. If the Respondent operated only as a miner of the mineral material that is used in the manufacture of cement, its depletion allowance would be based simply upon the gross income it derives from its mining activities. However, in addition to mining the Respondent also engages in a manufacturing operation whereby it transforms the minerals it mines into finished cement. Without question, the Respondent cannot base its depletion allowance on all of the income it derives from the sale of the finished cement, because at least a portion of that income is attributable to the enhanced value of the minerals after manufacturing.

The singular question presented to the Court in the case at bar involves a determination of that portion of the income from the sale of finished cement attributable solely to the Respondent's mining activities. This determination might be based upon the value of the mineral after the application of only mining activities if a market existed for the mineral at that point. However, in the cement industry no market exists for such mineral unless it is further manufactured into cement. When no actual market exists for the mineral prior to the application of

manufacturing processes, a constructive market price may be determined by the "proportionate profits method." This method allocates gross income from finished cement between mining and manufacturing activities according to a formula based on the relative cost of each activity. *The assumption on which the proportionate profits method is based, stated explicitly in the Treasury Regulations, is that each dollar of the total cost paid to produce finished cement earns the same percentage of income.*

The specific issues involved herein relate to whether income and costs attributable to certain "post-manufacturing" processes applied to the finished cement are includible in the proportionate profits formula. These processes include the bagging, storage and distribution of the finished cement. The Respondent would *exclude* from the formula all income or costs attributable to these post-manufacturing processes. In contrast, the Petitioner would *include* in the formula all *post-manufacturing* costs and income from actual sales of both bulk cement and *further processed cement* (*e.g.*, bagged cement).

B. Both the Respondent and the Petitioner agree that the formula requires the inclusion of the income and cost of the product first marketed in significant quantities (*i.e.*, the "first marketable product"). The Respondent's first marketable product is bulk cement sold at its plant. Numerous cases involving the determination of a representative market or field price for a mineral have held that the first marketable product is the mineral sold in bulk, not the mineral sold in bulk and bag, and there is no reason to reach a different conclusion where the proportionate profits method is required to determine gross income from mining.

Bagging and other post-manufacturing processes are *processes applied to bulk cement* and, therefore, produce a second marketable product. Nothing in the law suggests that costs associated with processes applied *after* the first marketable product is produced or any income attributable thereto are properly includible in the proportionate profits formula. To the contrary, the Petitioner's assertion that such cost and income are

includible is contrary to the Treasury Regulation which in essence states that the *first marketable product does not include any product that is further processed.* Bagging and other post-manufacturing activities are defined in the Treasury Regulation as "processes," and they are clearly undertaken after the first marketable product is produced.

The accounting conventions utilized by the Respondent are consistent with the decision in *United States v. Ideal Basic Industries, Inc.*, 404 F.2d 122 (10th Cir. 1968), *cert. denied*, 395 U.S. 936 (1969). The Petitioner's argument ignores the technical, economic and practical realities involved in the mining, manufacture and sale of cement, and if sustained will result in an unfair distortion of the Respondent's income.

C. To give effect to the assumption upon which the proportionate profits formula is based, the incremental income from and costs of the post-manufacturing processes must be excluded from the formula. Stated simply, after finished cement in bulk is produced, it is possible to determine precisely the cost and income attributable to any subsequent processes. Therefore, no approximation is necessary, and these items can and properly should be excluded from the formula.

The Petitioner insists that these incremental items of cost and income be included in the formula, even though this may negate the fundamental purpose of the formula, *i.e.*, to apportion income pursuant to the assumption that every dollar of cost produces the same percentage of income. Thus, even where the facts clearly demonstrate that the incremental costs produce little or, as here, no additional income, the Petitioner would include those costs in the formula. The formula was never intended to distort income in this manner.

II. If the position adopted by the Tenth Circuit permitting the complete exclusion of selling costs from the formula is rejected, the Treasury Regulations should be interpreted to permit a reasonable allocation of selling costs between mining and nonmining. The Petitioner arbitrarily maintains that no

reasonable allocation can be made in an industry populated exclusively by integrated miner-manufacturers. This position unjustifiably discriminates against such integrated miner-manufacturers. If the Petitioner's interpretation is correct, the Treasury Regulations should be held invalid as arbitrary and discriminatory.

ARGUMENT

I. THE INCREMENTAL INCOME AND COSTS ATTRIBUTABLE TO THE RESPONDENT'S POST-MANUFACTURING PROCESSES MUST BE EXCLUDED ENTIRELY FROM THE PROPORTIONATE PROFITS FORMULA.

A. Introductory Statement.

Section 611(a) of the Internal Revenue Code of 1954, as amended (hereinafter the "Code"), permits as a deduction in computing taxable income a reasonable allowance for depletion of mineral assets. Under Section 613(a) and (c) of the Code, the allowance for depletion is a specified percentage of the "gross income from the property" which, in the case of mineral property, means "gross income from mining."[1] Section 613(a) of the Code also limits the amount of the taxpayer's depletion allowance to 50% of the taxpayer's "taxable income from the property." The term "taxable income from the property" is defined as the taxpayer's gross income from mining, less all costs (excluding any deductions for depletion) attributable to the mining processes. Treas. Reg. §1.613-5(a).

The computation of "gross income from mining" depends on whether a nonmining process is applied to the extracted mineral before the mineral is sold. If the extracted mineral is sold before the application of a nonmining process, gross income from mining equals the actual amount for which the mineral is sold.

---

[1]The depletion rate for calcium carbonate rock, from which cement is made, was 15% for the Respondent's taxable year ended March 31, 1970, and 14% for its taxable years ended March 31, 1971 and 1972. Section 613(b)(7) of the Code.

Treas. Reg. §1.613-4(b)(1). "If the mineral is sold after the application of a nonmining process, gross income from mining is the representative market or field price for which the mineral could have been sold before application of any nonmining processes, if such a representative market or field price existed. Treas. Reg. §1.613-4(c)(1). If it is impossible to determine a representative market or field price for the mineral before application of nonmining processes, gross income from mining is determined pursuant to the proportionate profits method. Treas. Reg. §1.613-4(d)(1)(i). The purpose of the representative market or field price and proportionate profits methods is the same: to separate the gross income from the sale of the final product into (i) gross income from mining with respect to which a taxpayer is entitled to an allowance for depletion, and (ii) gross income from nonmining with respect to which the taxpayer is not entitled to an allowance for depletion.

With respect to the cement industry, Congress has specifically provided in Section 613(c)(4)(F) of the Code that all processes applied prior to the introduction of the kiln feed into the kiln are mining processes and that processes incurred subsequent thereto are not mining processes. Because no representative market or field price exists for kiln feed, and nonmining processes therefore must be applied before the first marketable product is available, integrated miner-manufacturers of cement utilize the proportionate profits method to compute gross income from mining. *Ideal Basic, supra.*

The proportionate profits method is a cost-oriented approach which allocates gross income from the "first marketable product" between gross income attributable to the mining processes and gross income attributable to the nonmining processes, on the basis of the relative cost of each. In particular, the proportionate profits method is a mathematical equation consisting, in part, of a fraction of which (i) the numerator is the sum of all direct costs incurred as a result of mining processes, plus an allocable share of all indirect costs that are not directly identifiable with a mining or nonmining process, and (ii) the denominator is the sum of all direct costs that are incurred as a

result of both mining and nonmining processes required to produce the first marketable product, plus all allocable indirect costs that are not directly identifiable with a mining or nonmining process. Treas. Reg. §1.613-4(d)(4); *see also Standard Lime & Cement Co. v. United States*, 329 F.2d 939, 944 (Ct. Cl. 1964). The resulting fraction is multiplied by the integrated miner-manufacturer's gross sales (actual or constructive) of the first marketable product.[2] The proportionate profits equation may be represented as follows:

$$\frac{\text{Mining Costs (Direct and Allocable Indirect)}}{\text{Total Costs to Produce the First Marketable Product (Direct and Allocable Indirect)}} \times \text{Gross Sales of First Marketable Product} = \text{Gross Income From Mining}$$

The determination of the integrated miner-manufacturer's first marketable product is critical to a correct application of the formula. In particular, the integrated miner-manufacturer is entitled to compute its gross income from mining only with reference to the income earned from the sales of its *least* processed product, *i.e.*, its first marketable product, *North Carolina Granite Corp.*, 56 T. C. 1281, 1291 (1971), *acq.*, 1974-2 C.B. 3, *nonacq.*, 1974-2 C.B. 5, because the incremental income derived from any process applied thereafter may be determined

[2]If an integrated miner-manufacturer of cement sold a portion of its cement in bulk but also further processed part of its cement into concrete bricks, the cement sold in bulk would be the first marketable product. For purposes of the proportionate profits formula, the integrated miner-manufacturer's gross sales would be an amount equal to its actual sales of cement plus its constructive sales price for the cement further manufactured into concrete bricks. *See* Treas. Reg. §1.613-4(d)(4)(v).

from empirical data without resort to the proportionate profits method.[3] If the integrated miner-manufacturer further processes a portion of its first marketable product, the gross sales to be used in the proportionate profits formula is the sum of (i) the proceeds from the actual sales of the first marketable product, and (ii) the proceeds from the constructive gross sales of the first marketable product which was further processed.[4] Moreover, since only costs incurred to produce the first marketable product are includible in the proportionate profits fraction, the cost attributable to any processes applied subsequent to the production of the first marketable product is excluded entirely from the fraction (*i.e.*, such cost is excluded from both the numerator and denominator).

The singular purpose of the proportionate profits formula is to provide an integrated miner-manufacturer with a constructive market price for a mined product, when no market price otherwise exists for that product. This formula does not utilize empirical data to determine the constructive market price of a particular product, but rather is an estimation employing the fiction that each dollar of the total cost paid to produce and sell the first marketable product earns the same percentage of profits. Treas. Reg. §1.613-4(d)(4). In general, this fiction serves adequately as a means of separating gross income from the first marketable product into its two components: gross income from *mining*, with respect to which the taxpayer is entitled to a depletion allowance, and gross income from *manufacturing*, with respect to which the taxpayer is not entitled to a depletion allowance.

---

[3] Because there is a market for bulk finished cement, any profit or loss resulting from subsequent processes can be determined precisely by comparison of the increase in price over that of bulk cement with the additional expenses incurred in applying the subsequent processes.

[4] Treas. Reg. §1.613-4(d)(4)(v) clearly contemplates the use of a constructive sales price for that portion of the first marketable product that is further processed in the taxpayer's operation. The same result obtained under the Treasury Regulations promulgated pursuant to the Internal Revenue Code of 1939, as amended. Treas. Reg. 118, §39.23(m)-1(e)(3).

In the case at bar, the Petitioner and the Respondent apparently agree as to the proper treatment within the proportionate profits method of direct costs incurred in connection with the mining or manufacturing processes. The threshold issues in this case are whether (i) the incremental cost associated with the post-manufacturing processes (*e.g.*, bagging, storage and distribution) are properly includible in either the numerator or the denominator of the proportionate profits fraction, and (ii) the incremental income from such processes are properly includible in the gross sales component of the formula.

The Petitioner asks the Court to extend the use of the proportionate profits formula beyond the purpose for which it is intended, so as to diminish the Respondent's gross income from mining. In particular, the Petitioner's method distorts the calculation by attributing income to post-manufacturing processes that without question are applied after the production of the first marketable product, *i.e.*, finished cement, even though these processes are demonstrably less profitable per unit than the mining and manufacturing operations and actually may result in a loss. The application of the formula urged by the Petitioner is clearly erroneous as applied to integrated miner-manufacturers of cement. *Ideal Basic, supra.*

B. The Incremental Income and Costs Incurred Subsequent to the Production of Finished Cement Must be Excluded from the Proportionate Profits Formula, Since the Respondent's First Marketable Product is Finished Cement Sold in Bulk at its Plant.

As noted previously, the proportionate profits formula is designed with explicit reference to the first marketable product. Stated differently, the *raison d'etre* of the formula is that it should be applied to the integrated miner-manufacturer's *least* refined or finished product for which a market exists. *North Carolina Granite Corp., supra,* 56 T.C. at 1291. The Court of Appeals for the Tenth Circuit, in *Ideal Basic, supra,* 404 F.2d at 125-26, held that the first marketable product of an integrated miner-manufacturer of cement is bulk cement and that bagged

cement is a second marketable product (*i.e.*, a more refined product than the first marketable product).[5]

The Petitioner contends that the Respondent's first marketable product is cement sold in bulk or bag and that the gross sales amount in the proportionate profits formula therefore must include the Respondent's actual total gross sales, whether in bulk or bags. Because the Petitioner applies the proportionate profits formula to the Respondent's actual sales, rather than to the actual or constructive sales of finished cement in bulk, it insists upon including bagging costs in the proportionate profits fraction, even though such costs are incurred after the production of cement, which the Petitioner concedes is a first marketable product. Moreover, because such incremental costs are incurred after the production of "kiln feed," the Petitioner concludes that they are nonmining costs that are includible only in the denominator of the proportionate profits fraction.

---

[5]Other than *Ideal Basic, supra,* and the opinions below in the case at bar, only two cases have actually addressed the issue of whether finished cement in bulk is the first commercially marketable product. The Ninth Circuit in *United States v. California Portland Cement Co.*, 413 F.2d 161 (9th Cir. 1969), held without a discussion of the issue that the first marketable product was cement in bulk or bag, citing as authority the Treasury Regulations and *Whitehall Cement Manufacturing Co. v. United States*, 369 F.2d 468 (3rd Cir. 1966). In *General Portland Cement Co. v. United States*, 628 F.2d 321 (5th Cir. 1980), the Fifth Circuit followed *California Portland* and *Whitehall Cement*, stating that *Ideal Basic* was wrongly decided as a result of the Tenth Circuit's misplaced reliance on *Standard Lime, supra,* and *United Salt Corp.*, 40 T.C. 359 (1963), *acq.*, 1973-2 C.B. 4, *aff'd*, 339 F.2d 215 (5th Cir. 1964). *But see* discussion of *United Salt, infra* at page 13.

In *Whitehall Cement*, the Third Circuit held only that *finished* cement was the first marketable product and that the incremental income and cost of the bagging operation must be included in the formula because the overall profits from the sale of bagged cement were attributable at least in part to the bagging process. This point is addressed *infra* at page 18. In *Standard Lime*, the Court of Claims expressly stated that it was not deciding whether bulk cement was the first marketable product. Neither *Mississippi Valley Portland Cement Co. v. United States*, 347 F. Supp. 240 (S.D. Miss. 1972), nor *Southwestern Portland Cement Co. v. United States*, 435 F.2d 504 (9th Cir. 1970), both cited by the Petitioner, expressly addressed the issue of first marketable product.

The Respondent asserted in the courts below that its first marketable product is bulk cement alone and that, therefore, the gross sales amount in the proportionate profits formula must be based upon the income it receives from the actual gross sales of bulk cement at its plant and the constructive gross sales of the bulk cement that was further processed. *Portland Cement Company of Utah v. Commissioner,* 614 F.2d 724 (10th Cir. 1979), *cert. granted*, 101 S. Ct. 69 (1980). Accordingly, the Respondent would exclude the bagging premium from the gross sales amount to which the proportionate profits fraction is applied and would also exclude the bagging costs from the proportionate profits fraction entirely.

Contrary to the Petitioner's assertion, the Respondent's first marketable product is only bulk cement, and not bulk and bag cement. This position finds clear support in Treas. Reg. §1.613-4(d)(4)(iv), which defines the term "first marketable product" as the product produced by the integrated miner-manufacturer in a form in which such product is first marketed in significant quantities. In that regard, it would appear indisputable that cement in bulk is the Respondent's product first marketed in significant quantities. While the Petitioner does not deny this conclusion, it asserts that cement in bag is essentially the same product as cement in bulk and that cement in bulk and bag therefore is the same marketable product. As will be discussed hereinafter, the Petitioner relies on Treas. Reg. §1.613-4(d)(4)(iv) to support this argument.

The Petitioner's assertion that cement in bulk and bag is the same marketable product denies the reality that cement in bulk must be processed further in order to become bagged cement. The Petitioner's own Treasury Regulations provide that the application of a nonmining process to the first marketable product creates a different product, no longer the first marketable product, and that bagging is such a nonmining process. Treas. Reg. §§1.613-4(d)(4)(iv) and 1.613-4(g)(4). Although the bagging process admittedly does not alter the physical or chemical characteristics of the cement in bulk (which, as noted hereinafter, appears to be the principal basis for the

Petitioner's position), it is nonetheless a nonmining process applied to cement in bulk that results in additional cost and income, and therefore, according to the Treasury Regulations, *bagged cement is not the first marketable product.*

The position that the Respondent's first marketable product is cement in bulk finds support in case law. As stated above, the court in *Ideal Basic, supra,* held that bulk cement is the first marketable product and that bagged cement is the second marketable product. 404 F.2d at 126. In the case at bar, that court reiterated its *Ideal Basic* holding that the first marketable product of an integrated miner-manufacturer of cement is bulk cement. While the Petitioner now rejects the simple logic of these decisions, it is interesting to note that, when it suited its purpose, the Petitioner has argued that bulk cement, and not bagged cement, is an integrated miner-manufacturer's first marketable product. *Standard Lime, supra,* 329 F.2d at 945, 948.

Furthermore, several cases that involved the determination of a representative market or field price for a mineral have held that the first marketable product is the mineral sold in bulk form, and that gross income from mining should be determined as if all of the product had been sold in bulk form. For example, in *Standard Realization Co. v. United States,* 289 F.2d 247 (7th Cir. 1961), the taxpayer argued that its gross income from mining was properly computed by reference to its actual sales of silica sand and flour in both bulk and bag. The Court of Appeals for the Seventh Circuit was unpersuaded by the taxpayer's argument, and stated that "it is hardly open to question but that taxpayer's product [in its raw state] was ready for industrial use or consumption . . . ." 289 F.2d at 254. As a result, the court concluded that the taxpayer's depletion base was the gross income it received from the sale in bulk of unground silica sand and flour in bulk and what it would have received if all its product had been sold in that form. Bagged sand was, in the court's words, "a more refined product." 289 F.2d at 254.

The Tax Court in *United Salt, supra,* agreed with the Seventh Circuit's decision in *Standard Realization.* The Tax Court considered a factual situation wherein a producer of salt sold its product in both bulk and bag. The Commissioner's position was that the producer's gross income from mining must be based on the total tonnage of salt sold, figured at the unit price for bulk salt.[6] The Tax Court agreed with the Commissioner, stating that bulk salt was the first marketable product and that, therefore, the bagged product was an additionally processed product, the income from which was not includible in gross income from mining. 40 T. C. at 368. *See also Ayers Materials Co.,* 62 T. C. 557 (1974); *Dravo Corp. v. United States,* 348 F.2d 542 (Ct. Cl. 1965).

Although *Standard Realization, supra,* and *United Salt, supra,* involved nonintegrated miners using representative market or field prices to determine gross income from mining, the logic that supports the conclusions of those cases is equally compelling when applied to an integrated miner-manufacturer of cement using the proportionate profits method. The Respondent's first marketable product is finished cement as it is produced by the manufacturing process. At that point, the cement may be and is in fact sold. The income to be derived from the finished cement is properly determined on a per ton basis at the Respondent's plant. *Ideal Basic, supra,* 404 F.2d at 126. Viewed from this perspective, it is at once apparent that the bagging process is a process applied to the Respondent's first marketable product, finished cement. Notwithstanding the Petitioner's assertion to the contrary, it is submitted that there is no justification for the Petitioner's position that the Respondent

---

[6]It is interesting that in *United Salt* the Commissioner argued that "the costs of sacking and sewing" marketable salt were not includible in the depletion base, 40 T. C. at 368, with the obvious results of decreased depletion and increased tax revenues. Here, in contrast, where a virtually identical argument would reduce revenues, the Petitioner renounces its prior position and asserts that the costs of bagging finished cement must be included, through the proportionate profits formula, in the depletion base.

must include in gross sales the incremental income from its bagging or any other process applied after the production of its first marketable product, finished cement in bulk.

To justify lumping bulk cement and bagged cement together as a single first marketable product, the Petitioner relies on Treas. Reg. §1.613-4(d)(4)(iv), which provides, *inter alia,* that bulk and packaged products are considered to be essentially the same product. Aside from this perfunctory conclusion of the Treasury Regulations, the Petitioner's position is based on a single proposition which may be stated thus: the nature of the first marketable product depends solely upon its physical and chemical characteristics, and because cement sold in bags has the same physical and chemical characteristics as cement sold in bulk, they are both the same first marketable product.

As support for that proposition, the Petitioner relies exclusively on *United States v. Cannelton Sewer Pipe Company,* 364 U.S. 76 (1960), wherein this Court was asked to determine the first commercially marketable product of a taxpayer that mined clay for use in the production of its vitrified sewer pipe. Under the then applicable depletion allowance provisions,[7] the term mining included not only the extraction of minerals from the ground but also the ordinary treatment processes normally applied by mine owners to obtain a *commercially marketable product.* The Government contended that the taxpayer's first commercially marketable product was the mined clay, since substantial quantities of clay were mined and sold in the taxpayer's marketing area. In contrast, the taxpayer asserted that its first commercially marketable product was the vitrified sewer pipe, since it could not sell its mined clay at a profit but had to process the clay further in order to earn a profit. This Court held in favor of the Government, stating that the term "commercially marketable product" meant the mineral first

[7]Internal Revenue Code of 1939, Section 114(b)(4)(B). The provisions of that Section were essentially carried over into Section 613(c) of the Code as it existed prior to the Public Debt and Tax Extension Act of 1960, Pub. L. 86-564, 86th Cong., 2d Sess.

produced by mining processes which was ready for industrial use or consumption, regardless of whether it could be marketed at a profit. 364 U.S. at 86. By way of *obiter dictum*, this Court commented that mining processes (as opposed to manufacturing processes) were those processes that did not destroy the physical or chemical identity of the minerals. 364 U.S. at 85-86.

The Petitioner relies on this *dictum* for the proposition that all products are identical if their physical and chemical properties are the same. All that *Cannelton* states, however, is that a manufacturing process causes a physical or chemical change in the raw mineral which exists after the application of mining processes. Contrary to the Petitioner's assertion, it does not follow from this *dictum* that *only* physical and chemical changes produce different products. At most, this Court in *Cannelton* found that a physical or chemical change in the raw mineral was one way to produce a different product. Stated simply, this Court did not address the issue of whether post-manufacturing processes (that admittedly do not alter the physical or chemical nature of a product) result in different marketable products.

The relevance of *Cannelton* to the proposition for which the Petitioner cites it is further diminished by the fact that, subsequent to the decision, Congress amended the depletion allowance provisions by removing the phrase "commercially marketable product."[8] Rather than leave open the question of when first marketability exists for any particular mineral, Congress listed the cut-off point for mining operations applicable to the various minerals, and thereby established the point at which the mining processes end. It is Section 613(c) of the Code, as presently in force and effect, that is involved in the case at bar. Under Section 613(c)(4)(A), (B) and (C) of the Code, the cut-off point (or last mining process) for coal, sulphur, and minerals sold in the form of crude minerals is the loading for shipment of those minerals. Accordingly, a miner that extracts those minerals may

---

[8]Public Debt and Tax Extension Act of 1960, Pub. L. 86-564, 86th Cong., 2d Sess.

compute its gross income from mining with reference to the gross sales price of those minerals loaded for shipment to the purchaser. Obviously, if the phrase "loaded for shipment" includes the mineral loaded in bulk, but not in bag, the miner's marketable product in bulk is a different marketable product than its marketable product in bag.

While Section 613 of the Code is silent as to whether the phrase "loaded for shipment" includes the mineral loaded in bag as well as bulk, the Treasury Regulations promulgated thereunder support the argument that the miner's marketable product is the mineral in bulk, and thus is the product with respect to which the representative market or field price is determined. Specifically, Treas. Reg. §1.613-4(g)(4) provides that packaging and the processing necessary or incidental thereto are *nonmining processes.* Applying that provision of the Treasury Regulations, the Petitioner has ruled that bagging is not part of loading for shipment as described in Section 613(c)(4) of the Code, but rather is a process applied subsequent to the point at which the representative market or field price of the mineral is determined. Accordingly, the income attributable to the bagging process is not includible in gross income from mining. *See* Rev. Rul. 72-476, 1972-2 C.B. 288; *Standard Realization, supra; United Salt, supra.*

It follows from the foregoing that bagging is a process applied to the miner's first marketable product in bulk and produces a *different* (or second) marketable product, notwithstanding the fact that the bagging process does not alter the physical or chemical nature of the mineral in bulk. The treatment for the minerals listed in Section 613(c)(4)(A), (B) and (C) of the Code demonstrates the fallacy of the Petitioner's argument that cement in either bulk or bag is the same marketable product.

For the foregoing reasons, we submit that the Respondent's first marketable product is bulk cement at the plant; bagged cement is a more refined and, therefore, second marketable product. It is not necessary to overrule Treas. Reg. §1.613-4(d)(4)(iv) in order to conclude that the Respondent's first

marketable product is bulk cement at the plant, and not bagged cement. In fact, the Tenth Circuit in *Ideal Basic*, applying regulations substantially identical to Treas. Reg. §1.613-4(d)(4)(iv), *see Portland Cement Co., supra*, 614 F.2d at 724, as well as in the case at bar, reached just that conclusion, and found bagged cement to be a *second* marketable product. Obviously, the provision in Treas. Reg. §1.613-4(d)(4)(iv) upon which the Petitioner relies so heavily, *i.e.*, that bulk *and* bagged product is the first marketable product, is only a generalized statement to be applied as facts and circumstances dictate. The facts and circumstances in the case at bar dictate that bulk and bagged cement be distinguished as different marketable products.

However, if the Petitioner insists that Treas. Reg. §1.613-4(d)(4)(iv) states a universal rule that would classify both bulk and bagged cement as the first marketable product, it is submitted that the Regulation is contrary to law and must be held invalid. The Treasury Department may not promulgate an arbitrary or unreasonable regulation. *United States v. Cartwright*, 411 U. S. 546 (1973); *Russell Manufacturing Co. v. United States*, 175 F. Supp. 159 (Ct. Cl. 1959). Nor should the Treasury Department be permitted to alter the law by regulatory fiat. As discussed above, the Petitioner's sole justification for the proffered application of Treas. Reg. §1.613-4(d)(4)(iv) is the *obiter dictum* in *Cannelton, supra*. As explained, this reliance on *Cannelton* is misplaced, because the case does not support the assertion that Treas. Reg. §1.613-4(d)(4)(iv) requires that bulk and bagged cement be considered the same marketable product. Moreover, it has been demonstrated that, for purposes of computing a representative market or field price, the bulk product is the first marketable product. In that respect, there simply is no justification for treating the bulk product as the first marketable product for purposes of determining a representative market or field price but not for purposes of the proportionate profits formula, except merely to raise additional tax revenues. Accordingly, it is submitted that the holdings of the Tax Court and Tenth Circuit in the case at bar should be affirmed.

C. The Incremental Income from and Costs of the Post-Manufacturing Operation Must Be Excluded Entirely from the Formula in Order to Give Proper Effect to the Assumption upon Which the Proportionate Profits Method Is Based (*i.e.*, Every Dollar of Cost Earns the Same Percentage of Profit).

As noted previously, the proportionate profits formula is based on a fiction that attributes a portion of the profit from the first marketable product to each dollar of cost incurred to produce and sell that product. With respect to mining and manufacturing costs, this fiction is one of necessity and convenience, since there is no empirical data to determine what percentage of the profits is attributable to these costs. However, when the processes are applied subsequent to the production of the first marketable product, it is possible to determine whether the subsequent processes earned profit. *See* note 3, *supra.*

In the case at bar, the costs attributable to the post-manufacturing processes were demonstrably less profitable than the costs of mining and manufacturing. Specifically, it is clear that the Respondent did not recover the incremental cost it incurred as a result of its bagging and distribution processes. To the contrary, the parties have stipulated that the bagging premium in each of the years in question was less than the cost of bagging and the bags, and, apparently, the cost of the distribution process was completely absorbed by the Respondent (*i.e.*, none of the cost of the distribution process was passed along to the purchasers). As a result, such incremental costs did not produce any *additional* profit for the Respondent. Instead, these costs resulted in a loss that diminished the Respondent's profits which it otherwise would have realized from sales of bulk cement at its plant.

When the facts establish that post-manufacturing processes do not earn a proportionate amount of the profit, the assumption on which the proportionate profits formula is based is violated unless (i) the fraction in the formula includes only the mining and manufacturing cost incurred by the Respondent to produce finished cement in bulk, and (ii) the gross sales in the formula

include only the total of the Respondent's actual gross sales of cement in bulk, plus the constructive gross sales of bulk cement further processed.

The Petitioner rejects calculating the constructive sales price in this manner because it asserts that such a calculation would be based on an erroneous assumption that the cost of the Respondent's post-manufacturing processes earns only the incremental income derived from the processes. More specifically, the Petitioner asserts that, if cement in bulk is sold for $100 per ton and in bag for $110 per ton (*i.e.*, a $10 per ton bagging premium) and the bagging costs are $15 per ton, the bagging cost earns not only the bagging premium of $10 but also a portion of the $100 sales price assigned to bulk cement.

As a basis for that assertion, the Petitioner states that it is reasonable to infer that the integrated miner-manufacturer's sale of the bagged product was an accommodation to the purchaser, induced sales, and contributed at least a portion of the profit. More specifically, the Petitioner asks the Court to infer that the Respondent would not have engaged in the unprofitable bagging process except as a means of realizing a portion of the profit from the ultimate sale, and that, therefore, the Respondent's unprofitable bagging operation should be deemed to have earned a portion of the profit from the ultimate sale.[9] For the following reasons, it is submitted that the Petitioner is in error with respect to its treatment of demonstrably unprofitable processes.

---

[9] In *Standard Realization, supra,* 289 F.2d at 253-255, and *United Salt, supra,* 40 T.C. at 366, the courts implicitly rejected the notion that any portion of the overall profit from the sale of the bagged product must be allocated to the bagging process, even though the product could not have been sold without first bagging the bulk product. Additionally, the inference has been rejected by the Petitioner's own Treasury Regulations as they apply to "purchased transportation" (which is transportation of the product to the customer in conveyances not owned by the taxpayer and with respect to which the taxpayer ordinarily does not earn any profit). Specifically, Treas. Reg. §1.613-4(e)(2) provides that the incremental income and cost attributable to purchased transportation shall be excluded entirely from the formula (*i.e.*, the incremental income is not included in gross sales and the incremental cost will be excluded from the denominator).

1. The Petitioner's suggested inference ignores the facts in the case at bar. Specifically, the record is silent as to the Respondent's specific reasons for incurring the bagging or other post-manufacturing costs. The Petitioner would have the Court hold that the Respondent would not have incurred the post-manufacturing cost if it could have sold all of its product in bulk at the plant. This unsupported conclusion is not justified. From an overall business viewpoint the Respondent may have had a variety of valid business reasons for incurring the bagging cost. For example, the Respondent may have chosen to incur the cost in order to increase customer goodwill or develop new markets.

2. In addition, the inference suggested by the Petitioner with respect to demonstrably unprofitable costs was flatly rejected by this Court in *Cannelton*, wherein the integrated miner-manufacturer asked the Court to infer that it would not have engaged in its unprofitable mining operation except as a means to realize a portion of the profit from the ultimate sale of its manufactured product and, therefore, that the integrated miner-manufacturer's unprofitable mining operation should be deemed to have earned the profit from the ultimate sale of the manufactured product. This Court held that the integrated miner-manufacturer's depletion allowance must be based on the representative market or field price of the first commercially marketable product of its mining operation, even though it could not sell the first commercially marketable product at a profit, but had to process the product further in order to make a profit. More specifically, this Court rejected the integrated miner-manufacturer's allocation of profit from the manufacturing operation to the unprofitable mining operation.

The plain meaning of this Court's holding in *Cannelton* is that when no profit is earned from a particular process, the unprofitable process may not be treated as earning any portion of the profits derived from a different process. Although *Cannelton* involved the determination of the integrated miner-manufacturer's first commercially marketable product, the

concept that this Court rejected there is identical to the concept that the Petitioner now asks the Court to apply in the context of the proportionate profits method.

3. The Petitioner's suggested inference also ignores the holdings of several courts that have addressed the issue and concluded that the incremental costs and income of less profitable processes must be eliminated completely from the formula. For example, in *North Carolina Granite, supra*, the Tax Court considered a factual situation involving an integrated miner-manufacturer of granite products. The taxpayer's nonmining operations took place in two separate departments (*i.e.*, Department I and Department II), both of which used rough granite mined from the taxpayer's quarries. Department I and Department II applied different nonmining processes to produce their respective finished products. The nonmining processes applied by Department II were more costly than the nonmining processes applied by Department I, and as a result, Department II produced little or no profit. In considering the correct application of the proportionate profits formula to that factual situation, the court concluded that:

> it is clear that not every dollar of cost in [taxpayer's] operations produced the same amount of profit. [Department II's] nonmining costs produced little or no profit when compared to the production of [Department I's] nonmining costs, and the inclusion of [Department II's] nonmining costs in the proportionate profits formula skews its results unfairly in the direction of nonmining gross income.

56 T.C. at 1290.

Contrary to the Commissioner's insistence that the proportionate profits formula must include the nonmining costs of the less profitable Department II, the Tax Court directed the parties to include in the formula only the costs of Department I. To avoid including the less profitable costs in the formula, the Tax Court found that Department I's product was the first

marketable product, *even though Department I's product was not used in or additionally refined by Department II.* In particular, the court found that the costs of the taxpayer's *least refined product* were the costs properly includible in the proportionate profits formula.

Applying the rationale of *North Carolina Granite* to the case at bar, it is clear that the incremental income (if any) and costs from the Respondent's post-manufacturing processes of bagging and distribution must be eliminated from the proportionate profits fraction. Specifically, the proportionate profits fraction should be constructed with reference to the Respondent's mining and manufacturing operations, since cement sold at the plant in bulk is the least refined product and the post-manufacturing processes of bagging and distribution are demonstrably less profitable (if profitable at all) than the mining and manufacturing operations. To include in the formula the incremental cost and profit attributable to the bagging and distribution processes would, in the words of the Tax Court, "skew its results unfairly in the direction of nonmining gross income." 56 T.C. at 1290.

The holding in *North Carolina Granite* is further supported by *United States v. Portland Cement Company of Utah,* 378 F.2d 91 (10th Cir.), *cert. denied,* 389 U.S. 975 (1967), wherein Judge Breintenstein, writing for the majority, stated:

> If the inclusion of unproductive costs so distorts the equation that the application of the formula does not in fact clearly reflect the gross income from the property they may be excluded.

378 F.2d at 94.

4. Unless the incremental cost and income attributable to post-manufacturing processes are eliminated from the proportionate profits formula, the taxpayer who calculates gross income from mining by reference to a representative market or

field price may receive a decided tax advantage over the taxpayer who calculates gross income from mining by use of the formula. This disparate treatment may be stated thus: in the proportionate profits formula, bagging costs are deemed to have earned not only the bagging premium, but also a portion of the income which would have been received had the mineral been sold in bulk, whereas a representative market or field price calculation may be based on the constructive sales price of the mineral in bulk, with no portion of that price attributed to the bagging costs.[10] To the extent the Regulations require this discriminatory result, they must be found to be invalid, since such disparate treatment should not exist between those that use the representative market price and those that use the proportionate profits method.

This point may be illustrated by the example in Appendix A, which compares an integrated miner-manufacturer in an industry where a representative market price exists for the mineral before nonmining processes and an integrated miner-manufacturer in an industry required to use the proportionate profits formula.

---

[10]The requirements regarding the calculation of a representative market or field price are set forth in Treas. Reg. §1.613-4(c). Of specific interest is Treas. Reg. §1.613-4(c)(6), which provides: "It shall be presumed that a price is not a representative market or field price for the taxpayer's ore or mineral if the sum of such prices plus the total of all costs of nonmining processes . . . which the taxpayer applies to his ore or mineral regularly exceeds the taxpayer's actual sales price of his product." If this requirement cannot be satisfied, the taxpayer must use the proportionate profits method to calculate its gross income from mining attributable to the nonmining processes.

In the example in Appendix A, the integrated miner-manufacturer broke even on its bagging process and, therefore, would be entitled to compute its gross income from mining under the representative market or field price method, notwithstanding the provisions of Treas. Reg. §1.613-4(c)(6). However, even if the integrated miner-manufacturer's bagging cost exceeded the bagging premium, it should be entitled to compute its gross income from mining not by use of the proportionate profits method, but by use of the representative market or field price method, because Treas. Reg. §1.613-4(c)(6) is an arbitrarily discriminatory provision and should be found invalid.

The unconscionable nature of Treas. Reg. §1.613-4(c)(6) has been described by one commentator as follows:

> In this provision the Commissioner takes a "heads I win, tails you lose" attitude. If the transportation or conversion operation results in

5. Finally, the proportionate profits formula as applied by the Petitioner to determine the Respondent's "gross income from mining" further compounds the inequitable treatment described above by adversely affecting the Respondent's depletion allowance with respect to its sale of *bulk* cement. Specifically, in the formula that the Petitioner seeks to apply, *bagging costs* are considered to have earned a portion of the profits from *bulk* sales of cement, notwithstanding that the bulk sales were totally unrelated to the bagging costs. In particular, in the proportionate profits fraction every dollar of cost is deemed to have earned an allocable share of gross sales. Thus, if the denominator includes bagging costs and gross sales includes both bagged and bulk sales (as the Petitioner contends), the bagging costs are deemed to have earned not only a portion of sales attributable to bagged sales but also a portion of the sales attributable to bulk sales. This is clearly contrary to the facts as indicated in the record of this case: the bagging costs did not earn any portion of the bulk sales, but were incurred in separate and unrelated sales. This point is illustrated by the example in Appendix B.

> a substantial profit, no part of that profit increases the gross income of the property; but if the transportation or conversion operation results in a loss, that loss reduces gross income from the property. It is difficult to understand why this result should follow. I can understand that the taxpayer should not be allowed to treat as gross income from the property an amount which is actually attributable to a transportation or conversion process, but once the taxpayer is able to demonstrate that the transportation or conversion process actually did produce a loss, whatever the reason, that loss should not then be attributed to the producing operation and result in a reduction of the gross income from the property.

Collier, "The New Depletion Regulations," 1970 Tulane Tax Institute 510, 530 (1970).

The test set forth in Treas. Reg. §1.613-4(c)(6) is not relevant to a determination of the actual representative market or field price. Assuming that a price is otherwise representative, the fact that the producer may incur a loss in connection with a subsequent process is irrelevant. Congress enacted Section 613 of the Code to compensate the miner for the exhaustion of his mineral asset based on the income derived from constructive sales of the raw mineral product. *Cannelton, supra.* The profitability of processes applied subsequent to the constructive sale bears no relation to the producer's depletion deduction.

It is clear that only the mining and manufacturing costs incurred in connection with the sale of bulk cement may be properly included in the proportionate profits formula used to determine gross income from mining of bulk cement. Any other result would be contrary to this Court's decision in *Cannelton, supra,* wherein the Court noted that gross income from mining must not contain any element of cost or profit attributable to a nonmining or finishing process. The Court's postulate stated in the converse is that gross income from manufacturing must not contain any element of cost or profit attributable to a mining process. In the case at bar, as in the example in Appendix B, the Petitioner's position has the effect of attributing a portion of the mining income to nonmining processes. Contrary to this Court's opinion in *Cannelton, supra,* it denies the taxpayers the income attributable solely to the mining process.

For the reasons stated in paragraphs 1 through 5, it is submitted that the incremental income and costs of the post-manufacturing operation must be excluded entirely from the formula in order to give effect to the assumption of the proportionate profits formula (*i.e.*, every dollar of cost earns the same percentage of income).

II. THE RESPONDENT'S SELLING EXPENSES ARE NOT IDENTIFIABLE WITH EITHER A MINING OR NONMINING PROCESS. ACCORDINGLY, SELLING EXPENSES MUST BE APPORTIONED BETWEEN MINING AND NONMINING BY A REASONABLE METHOD, UNLESS THE DECISIONS OF THE TENTH CIRCUIT ARE FOLLOWED AND SELLING EXPENSES ARE EXCLUDED ENTIRELY FROM THE PROPORTIONATE PROFITS FRACTION.

The Tenth Circuit in *Ideal Basic, supra,* 404 F.2d at 126, and in the case at bar, excluded selling expenses entirely from the

proportionate profits fraction (*i.e.*, selling expenses were not included in either the numerator or denominator of the fraction). This position is not the one indicated by Treas. Reg. §§1.613-4(d)(4)(iii) and 1.613-5(c)(4)(ii), which permit only an allocation of selling costs between mining and nonmining, but is required by *Ideal Basic* and the opinion below. The Petitioner's position is not only contrary to that of the Tenth Circuit, but is also inconsistent with the Treasury Regulations cited above, and is most onerous to the Respondent and all other integrated miner-manufacturers of cement, in that it would disallow any allocation of the selling expenses between mining and nonmining. The remainder of this *amicus curiae* brief will be directed toward the proposition that, at the very least, such selling expenses must be prorated between mining and nonmining in the proportionate profits formula.

Treas. Reg. §1.613-4(d)(4)(iii) and the decisions of the Ninth Circuit and Fourth Circuit require that the Respondent allocate the selling costs between its mining and manufacturing processes based upon a reasonable method.[11] The Petitioner objects, however, to any allocation of selling costs to the mining process, unless the Respondent can demonstrate that selling costs are typically incurred by a *nonintegrated* miner of cement, *i.e.*, a miner engaged in selling its mineral before the application of any nonmining processes. In the case at bar, the Petitioner contends that the Respondent has failed to show that a nonintegrated miner of cement typically incurs selling costs.

For the Respondent, and all other integrated miner-manufacturers of cement, the Petitioner's position creates an anomaly which may be stated thus: an integrated miner-manufacturer of cement cannot demonstrate that a nonintegrated miner of cement typically incurs selling expenses, since the cement industry is fully integrated, *i.e.*, there are no nonintegrated miners of kiln feed. In essence, the Petitioner argues that, for fully integrated industries, there is an

---

[11] *Southwestern Portland Cement, supra,* 435 F.2d at 508; *Arvonia-Buckingham Slate Co. v. United States,* 426 F.2d 484, 486 (4th Cir. 1970); *California Portland, supra,* 413 F.2d at 170.

irrebuttable presumption that no reasonable method may be established for the allocation of selling expenses between mining and nonmining processes. Such an irrebuttable presumption is arbitrary and unreasonable and has been rejected implicitly by the courts.[12] Furthermore, the result sought by the Petitioner is not required by the Treasury Regulations.

The Petitioner relies exclusively on Treas. Reg. §§1.613-4(d)(4)(iii) and 1.613-5(c)(4)(ii). Treas. Reg. §1.613-4(d)(4)(iii) provides that costs that are not directly identifiable with a mining or nonmining process must be apportioned between mining and nonmining by use of a reasonable method. For the rule with respect to selling expenses, Treas. Reg. §1.613-4(d)(4)(iii) refers to Treas. Reg. §1.613-5(c)(4)(ii), which provides that for purposes of computing taxable income from the property (*i.e.*, gross income from mining less mining cost), an integrated miner-manufacturer must deduct as a mining cost a reasonable portion of its selling expenses.

The purpose of Treas. Reg. §1.613-5(c)(4)(ii) is to maintain equality between an integrated miner-manufacturer and a nonintegrated miner in the same industry with respect to the computation of taxable income from the property. To that end, Treas. Reg. §1.613-5(c)(4)(ii) requires an integrated miner-manufacturer to reduce its gross income from mining by that portion of its selling expenses which equals the typical selling expenses incurred by a nonintegrated miner in the same industry. If a nonintegrated miner in the industry does not incur selling expenses, the integrated miner-manufacturer in that same industry is not required in computing taxable income from the property to reduce its gross income from mining by any portion of its selling expenses.

The above-referenced Treasury Regulations neither state explicitly nor imply that the integrated miner-manufacturer in a fully integrated industry is precluded from allocating a reasonable portion of its selling expense to its mining operation. Indeed, Treas. Reg. §1.613-5(c)(4)(ii) is silent on that point,

---

[12] *See* note 11, *supra*.

because the policy underlying that provision (*i.e.*, to maintain equality between the integrated and nonintegrated miner in the same industry) is not applicable to the fully integrated industry. Accordingly, the Respondent must follow the general provisions of Treas. Reg. §1.613-4(d)(4)(iii) regarding expenses not directly identifiable with a mining or nonmining process and allocate its selling expenses between mining and nonmining on a reasonable basis. As hereinafter discussed, the courts have held that, in the cement industry, a reasonable method of allocation may be on the ratio of direct mining cost to total mining and manufacturing cost.[13]

If, notwithstanding the foregoing argument, Treas. Reg. §1.613-4(d)(4)(iii) by its reference to Treas. Reg. §1.613-5(c)(4)(ii) is read as precluding an allocation of selling expenses to mining processes in the fully integrated industry, we submit that the Regulations must be held invalid. In particular, Treas. Reg. §1.613-4(d)(4)(iii) specifically permits the allocation of expenses which are not directly identifiable with either a mining or nonmining operation. Examples of such costs are general overhead expenditures and selling expenses.[14] With respect to the former type of expense, Treas. Reg. §1.613-4(d)(4)(iii) permits an allocation between mining and nonmining on a reasonable basis, without regard to whether the producer is in a fully integrated industry. Any interpretation of the Treasury Regulations that would single out from a category of cost one particular item, *i.e.*, selling expenses, for special treatment is both arbitrary and unreasonable. Stated simply, there is no valid reason for treating selling expenses differently than the other items of cost that are not directly identifiable with either a mining or nonmining operation. If the Treasury Regulations permit an allocation on a reasonable basis for one item of expense in the category, they must likewise permit an allocation for all items of expense in the category.

---

[13] *See* discussion *infra* at page 29.

[14] *Arvonia-Buckingham Slate, supra*, 426 F.2d at 486; *California Portland, supra*, 413 F.2d at 170.

Also, contrary to the Petitioner's assertion, there appear to be no cases specifically rejecting the position that a reasonable portion of selling expenses may be allocated to the cement producer's mining processes. The Court of Claims in *Standard Lime, supra,* is silent with respect to the issue of whether selling expenses are allocable between the taxpayer's mining and nonmining operations. In fact, the court was neither presented with nor did it address that specific issue. In *Mississippi Valley, supra,* 347 F. Supp. at 243, the District Court acknowledged the holding of the Ninth Circuit in *California Portland, supra,* 413 F.2d at 170, that selling expenses are properly allocated between mining and nonmining. However, without stating that it was refusing to follow *California Portland,* the District Court held that the expenses of selling were all nonmining costs, apparently because such selling expenses were incurred by the taxpayer's *agent,* rather than the taxpayer. The Petitioner also refers to the statement by the Tenth Circuit in *Ideal Basic, supra,* 404 F.2d at 126, that selling expenses are nonmining costs. However, reliance by the Petitioner on *Ideal Basic* seems misplaced, because, as stated previously, the Tenth Circuit specifically excluded selling expenses entirely from the formula.

A review of the court decisions that do address the issue of the proper treatment of selling expenses in the proportionate profits formula reveals that such costs are partially allocable to the integrated miner-manufacturer's mining operation. In particular, in *California Portland, supra,* 413 F.2d at 170, the Ninth Circuit found that a cement producer's selling expenses were not direct costs identifiable with either the mining or manufacturing phase, but rather were incurred for the benefit of the entire operation. The court concluded that the selling expenses could be allocated in the proportion that mining costs

bore to the total costs. *Accord, Southwestern Portland Cement, supra,* 435 F.2d at 508. The Fourth Circuit reached a similar conclusion in *Arvonia-Buckingham Slate, supra,* 426 F.2d at 486. Of particular interest in the latter case is the Fourth Circuit's comment that common knowledge reveals that selling expenses benefit both mining and nonmining activities. Thus, the court concluded that selling expenses, like general overhead expenditures, are not directly identifiable with either a particular mining or nonmining process, and were, therefore, to be allocated in the proportion that the mining costs bore to the total costs.

For the foregoing reasons, it is submitted that the Treasury Regulations should be interpreted to provide an allocation of selling expenses of an integrated miner-manufacturer of cement between mining and nonmining, based on a reasonable method. If, however, the Treasury Regulations are interpreted to require a different result, the Regulations should be held invalid.

CONCLUSION

The judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

RICHARD A. FRELING
DAVID G. GLICKMAN
WILLIAM P. BOWERS

APPENDIX A

This example compares an integrated miner-manufacturer in an industry where a representative market price exists for the mineral before the application of nonmining processes and an integrated miner-manufacturer in an industry required to use the proportionate profits formula. Assume that both integrated miner-manufacturers sold one ton of their respective products and that each had the following results of operation:

Representative Market Price:

Gross Sales:	$200	per ton bulk product
Representative Market Price:	$100	per ton bulk product
Manufacturing Cost:	$ 20	per ton
Mining Cost:	$ 20	per ton
Bagging Cost:	$ 30	per ton
Bagging Premium:	$ 30	per ton

Proportionate Profits Method:

Gross Sales:	$200	per ton bulk product
Mining Cost:	$ 20	per ton
Manufacturing Cost:	$ 20	per ton
Bagging Cost:	$ 30	per ton
Bagging Premium:	$ 30	per ton

Considering first the situation where the product was sold in bulk form only, each producer's gross income from mining would be $100, which is computed as follows:

Representative Market Price:

Gross Income From Mining = $100 Representative Market Price

Proportionate Profits Method:

$$\frac{\text{\$20 Mining Cost}}{\text{\$40 Total Mining and Manufacturing Cost}} \times \text{\$200 Gross Sales} = \text{\$100 Gross Income From Mining}$$

However, if the product is sold in bags, and the bagging costs are treated as suggested by the Petitioner, the proportionate profits method yields a gross income from mining equal to $65.71, and the representative market price still yields a gross income from mining equal to $100.00, which amounts are calculated as follows:

Representative Market Price:

Gross Income From Mining = $100 Gross Sales

Proportionate Profits Method:

$$\frac{\text{\$20 Mining Cost}}{\text{\$70 Total Cost}} \times \text{\$230 Gross Sales} = \text{\$65.71 Gross Income From Mining}$$

The difference between the gross income from mining computed under the proportionate profits method ($65.71), and the gross income from mining computed per the representative market price ($100), is the result of the fact that, in the proportionate profits method, the bagging costs are deemed to earn not only a portion of the bagging premium, but also a portion of the constructive sales price of the first marketable product.

APPENDIX B

Assume that the integrated miner-manufacturer's results of operation are as follows:

		Sales Price
Two Tons of Cement were Sold:		
One Ton was sold in bulk		$150
One Ton was sold in bagged form:		
Bulk Price	$150	
Bag Premium	10	160
Total Sales Price		$310

	Costs
Mining Cost ($25 per ton)	$50
Manufacturing Cost ($12.50 per ton)	25
Bagging Cost ($15 per ton)	15
Total Cost	$90

In the Petitioner's proportionate profits fraction applicable to that illustration, the numerator would consist of mining cost of $50 and the denominator would consist of mining, manufacturing and bagging costs of $90. The fraction so constructed (*i.e.*, 50/90) would then be multiplied by the producer's *actual sales of bulk and bagged cement* (*i.e.*, $310) and is illustrated thus:

$$\frac{\$50 \text{ Mining Cost}}{\$90 \text{ Total Cost}} \times \$310 \text{ Gross Sales} = \$172.22 \text{ Gross Income From Mining}$$

More specifically, the *same* fraction (50/90) would be multiplied by the producer's sales price of bulk cement ($150) *and* bagged cement ($160):

$$\frac{\$50 \text{ Mining Cost}}{\$90 \text{ Total Cost}} \times \$150 \text{ Gross Sales Bulk} = \$83.33 \text{ Gross Income From Mining}$$

and:

$$\frac{\$50 \text{ Mining Cost}}{\$90 \text{ Total Cost}} \times \$160 \text{ Gross Sales Bagged} = \$88.89 \text{ Gross Income From Mining}$$

Total Gross Income From Mining: $172.22

In the terms of the assumption on which the equation is based, every dollar of mining cost in the example earns 55% (*i.e.*, 50/90) of every dollar of income, regardless of whether the income results from a sale of bulk cement or bagged cement. Every dollar of mining cost in the producer's operations did not produce 55% of each dollar of income, however. Rather, with respect to the cement sold in bulk form, every dollar of mining cost earned *66%*, not 55%, of every dollar of income.

In the proportionate profits fraction, as the Respondent argues it should be applied to the sale of bulk cement, the numerator would consist of mining cost of $50 and the denominator would consist of mining and manufacturing costs of $75. The fraction so constructed (*i.e.*, 50/75) would then be multiplied by the producer's actual sale of bulk cement (*i.e.*, $150) and is illustrated thus:

$$\frac{\$50 \text{ Mining Cost}}{\$75 \text{ Total Cost}} \times \$150 \text{ Gross Sales Bulk} = \$100 \text{ Gross Income From Mining}$$

The fraction applied to the gross sales price of the bagged cement would consist of a numerator of $25 (mining cost) and a denominator of $52.50 (mining, manufacturing, and bagging cost) and would be applied thus:

$$\frac{\$25 \text{ Mining Cost}}{\$52.50 \text{ Total Cost}} \times \$160 \text{ Gross Sales Bagged} = \$76.19 \text{ Gross Income From Mining}$$

In the bagged sale, every dollar of mining cost earns 47.6% of every dollar of income. The critical fact, however, is that by applying the two different fractions to their respective gross sales amounts (*i.e.*, bulk and bag), the producer has gross income from mining equal to $176.19, which is $3.97 more than the gross income from mining derived under the Petitioner's application of the proportionate profits formula. More specifically, the weighted average of the two fractions is 56.8% [(66% + 47.6%) ÷ 2], which is greater than the 55% derived by the Petitioner's application of the formula.